EXECUTIVE SECRETARIAT

ROUTING SLIP

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		ACTION	INFO	DATE	INITIAL
1	DCI				
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9	Chm/NIC				
10	GC				
11	IG				
12	Compt				
13	D/OLL				
14	D/PAO				
15	VC/NIC				
16	NIO/ECON		X		
17	D/OGI		X		
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SUSPENSE ______________
Date

Remarks

STAT

Executive Secretary

10 Aug 84

Date

3637 (10-81)

MINUTES
ECONOMIC POLICY COUNCIL

July 31, 1985
2:00 p.m.
Roosevelt Room

Attendees: Messrs. Baker, Block, Baldrige, Yeutter, Sprinkel, Whitehead, Darman, Burnley, Wright, Kingon, McAllister, Oglesby, Cornell, Driggs, Holmer, Khedouri, Mulford, Smart, Whitfield, Wigg, Cohen and Stucky.

1. Common Fund

Mr. Cornell, noting that the Council had reviewed the issue of whether the U.S. should join the Common Fund at an earlier meeting, explained that the question remaining is, should the U.S. publicly announce an intention not to ratify the Common Fund Agreement.

Several members of the Council spoke in favor of announcing our intentions not to ratify, with the possibility of encouraging other nations to follow our lead. Others expressed concern that U.S. vagueness might be interpreted as disingenuousness, particularly by the developing nations.

The Council also discussed the possibility of the Soviet Union ratifying the Common Fund Agreement and the likely effect that would have on U.S. interests.

Decision

Secretary Baker asked the Executive Secretary to poll later each member of the Council as to whether the U.S. should publicly announce a decision not to ratify the Common Fund Agreement or maintain the current policy of leaving the possibility of U.S. ratification open.

2. U.S.-EC Steel Negotiations

Ambassador Yeutter outlined the current status of U.S.-EC negotiations on the consultation steel products, noting that he is actively discussing the issue with EC Commissioner De Clercq. The U.S. has threatened to take unilateral action against the EC on August 1.

Ambassador Yeutter traced the history of the negotiations over the consultation products. Consultation products were excluded from the 1982 U.S.-EC Steel Arrangement because EC exports of these products to the U.S. were relatively insignificant through 1981. However, the Steel Arrangement provides that if imports of consultation products show a significant increase, indicating the possibility of diversion

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from the licensed products, consultations will be held "with the objective of prevent such diversion, taking into account the 1981 market share levels." The first EC offer for restraint, made on July 19, would have resulted in an increase in imports above the 1984 level. Their most recent offer would establish the limit at 538,000 tons, 10 percent below the 1984 level. Commissioner De Clercq however informally has offered an 505,000 ton limit.

Ambassador Yeutter stated that the most recent U.S. offer is 475,000 (on an annual basis) for the second half of 1985, well above the 332,000 tons imported in 1981, and 25 percent below the E.C.'s 1984 level of 634,000 tons. The U.S. also allowed entry of 100,000 tons of EC pipe for the All American pipeline in order to facilitate negotiations. He also noted that the EC has threatened to retaliate against U.S. agricultural exports, should the U.S. unilaterally impose restraints against consultation products imports.

Secretary Baldrige stated that the issue was not just the difference of 25,000 tons of consultation products but also about how we negotiate with the EC trading partners. He noted that in the past, the U.S. typically has compromised, while the EC typically has remained intransigent. He also observed that since the 1982 Steel Arrangement EC exports of consultation products have increased 2.6 percent in 1982, 8.7 percent in 1983, and 9.6 percent in 1984.

Secretary Block stated that, although the EC may retailiate against agricultural products, unilateral action may be the only kind of signal that would affect the EC. Mr. Sprinkel indicated that trade restraints are harmful and that unilateral action may spawn greater, not fewer, trade restraints.

The Council discussion focused on the U.S.'s lack of success in dealing with the EC and the likely Congressional reaction to a failure on the part of the Administration to back its threat of unilateral action.

Decision

Secretary Baker asked that a memorandum be prepared for the President, outlining the issue, the major arguments, and the options, and indicating the recommendations of each agency. The Treasury, the Departments of Commerce and Agriculture, the National Security Council, and the Office of Management and Budget supported unilateral restraint. The State Department and the Council of Economic Advisers supported continuing negotiations.

THE WHITE HOUSE

WASHINGTON

July 31, 1985

MEMORANDUM FOR THE PRESIDENT

FROM: THE ECONOMIC POLICY COUNCIL

SUBJECT: Agricultural Credit Policy

Although it affects only a relatively small group of farmers, a significant portion of outstanding farm credit is in trouble. As of January 1985, 9.9 percent of all farmers had debt to asset ratios over 40 percent and negative cash flow; these farmers owed 45.3 percent of all farm debt. Field crop and livestock operators in the Corn Belt, Lakes States and Southern Plains are facing the greatest financial difficulties.

Without policy changes, the agricultural credit problem will deteriorate rapidly in the next few months. The issue is what, if any, changes the Administration should seek in the operations of the Farmers Home Administration (FmHA), and the Cooperative Farm Credit System (FCS) to ensure the current and future viability of farm credit assistance, without explosively increasing Federal spending.

Origins of the Agricultural Credit Problem

The farm sector is now undergoing an inevitable and necessary correction to the extraordinary agricultural boom of the mid- and late-1970's. Overall demand for U.S farm products grew rapidly, with export markets expanding dramatically. Increased demand, rising productivity, and declining labor inputs caused real income from assets to rise sharply. In response to these incentives, augmented by government farm support programs, the tax code, and negative real interest rates, capital investment in agriculture increased and land values were bid up. Debt rose about as fast as the increase in assets and an increasing share of debt was provided by the Federal Government and the Farm Credit System.

In the 1980's, the boom of the 70s was reversed. The appreciation of the dollar and the slowdown in economic growth abroad slashed exports. The relative decline in demand, combined with several bumper crop years, undermined farm prices. High interest rates over the last six years also reduced income. The less profitable outlook for farming, high real interest rates, and reduced inflationary expectations, pulled down farm land prices and assets while debt rose, squeezing farm equity.

Previous Administration Actions

In response to rising concerns about the deteriorating conditions in farm finances and the adequacy of operating credit, the Administration initiated in September 1984 a series of actions to provide adequate crop loans for 1985. These initiatives, along with greater credit from commercial banks and private individuals, resulted in all but about 5 percent of farmers obtaining operating credit for the current year -- instead of the 15 percent or higher shortfall predicted at the beginning of the lending season.

In February 1985, the Administration made a commitment to increase significantly short-term FmHA direct lending. FmHA currently projects $4.25 billion will be lent directly by the end of FY 1985, compared with the $2.57 billion planned in the budget. The guaranteed lending program, after a slow start-up, should commit $1.1 billion by the end of FY 1985, compared with the $700 million planned in the budget.

Objectives of Further Actions

The Administration has several objectives in addressing the agricultural credit problem:

- It should establish a framework in which the flow of credit into the agricultural sector eventually conforms more closely with the market allocation of credit.

- It should minimize the short- and long-term budget costs of any solution.

- It should ensure that any credit solution is consistent with our overall agricultural policy.

Farmers Home Administration (FmHA)

The financial problems of the farm sector are adversely affecting the FmHA. From October 1 through June 19 of FY 1985, FmHA provided about $4.6 billion in direct and guaranteed loans to farmers -- a 92 percent increase over the same period in FY 1984. Direct loans made up 82 percent of the total credit provided. Most of the lending is to new borrowers. About 30 percent of all FmHA loans, or $8.5 billion, is delinquent. The higher lending in 1985 has increased the loss exposure on these loans.

The dramatic increase in FmHA exposure is due to its position as a "lender of last resort." The FCS and commercial banks are turning away many borrowers and directing them to the FmHA for their operating loans. Although these operating loans are not provided for real estate purposes, they enable the borrower to service his or her existing real estate debt. These loans have become de facto entitlements, which the FmHA virtually cannot foreclose.

Given current conditions, FmHA inhibits the necessary restructuring of the farm sector, which further depresses land values and forces more borrowers out of the FCS and banks and into the FmHA. The potentially large demand for FmHA credit would undermine the Administration's efforts to reduce Federal spending.

Cooperative Farm Credit System (FCS)

The FCS was originally created as a Government-sponsored enterprise. The FCS is able to borrow at about 5-20 basis points above Treasury securities because the market believes its securities are backed by the Federal Government, even though there is no explicit guarantee.

The overall condition of the FCS is basically sound. Of the $13 billion in stock, retained earnings, and loss allowances, the FCS has $4 billion to $6 billion in relatively liquid assets and also holds about $500 million to $1 billion of short-term lines of credit.

Notwithstanding the overall sound condition of the FCS, several elements of the system are facing severe financial difficulties. Several problem districts, particularly the Omaha district (including Nebraska, South Dakota, Iowa, and Wyoming), may require a total of about $1.8 billion within 60-90 days to stabilize their competitive position.

The fundamental problems faced by the FCS are two-fold:

1. The system is highly decentralized and operates on a consensus management basis. Because the FCS' equity is spread among about 900 separate entities and these entities are required to share losses only if there is a technical default, districts requiring additional equity in order to stabilize operations cannot easily draw on the reserves of other districts.

2. The Farm Credit Administration, which oversees the FCS, lacks regulatory authority and the necessary enforcement powers to require acceptable credit standards.

Policy Options

Option 1: Limit FmHA direct lending to servicing its existing portfolio. Eliminate FmHA real estate lending. Authorize FmHA to guarantee new operating loans up to a maximum of 70 percent under existing qualification rules.

Encourage the FCS to solve its problems without Federal aid or interference.

Advantages

- Closing the FmHA direct credit window and ending real estate loans minimizes Federal budget outlays which have grown at unprecedented rates.
- Having the commercial market carry significant portions of the risk on guaranteed loans helps insure the viability of these loans.
- Having the FCS put itself back on a sound financial basis through loan liquidation and more stringent standards for new loans would help make the flow of agricultural credit more consistent with a market allocation of credit.

Disadvantages

- This option would curtail some loan activity. More marginal farmers would have to liquidate their assets hastening an already rapid decline in asset values.
- If FCS were to default on its obligations and were unable to provide credit, the farm sector would face substantial contraction as available credit diminished.
- Not providing Federal assistance now may result in greater costs of assistance later if it appears the system were going to default in the future.

Option 2: Limit FmHA direct lending to servicing its existing portfolio. Limit FmHA real estate lending to no more than current levels. Continue FmHA guaranteed loans under existing authorities (maximum of 90 percent guarantee) under existing qualification rules.

Encourage the FCS to solve its problems without Federal aid or interference.

Option 2 differs from option 1 by: permitting FmHA to maintain current levels of real estate lending and maintaining the FmHA loan guarantee level at 90 percent.

Advantages

- Closing the direct credit window at FmHA eases the short run pressure on budget outlays.
- Eases the adjustment for farmers by promoting slower transfer of unproductive resources out of agriculture.
- This approach could be implemented through regulations and, in the case of FCS by their independent action, and would not require Congressional approval.

Disadvantages

- Absorbing most of the risk on guaranteed loans promotes lower quality loans by commercial lenders, significantly increasing the ultimate Federal budget exposure.

- Continuing FmHA activity in a deteriorating land market enhances the possibility of long term budget outlays from defaulted real estate loans.

- Some Agricultural Committee members may feel the Administration has exceeded its regulatory discretion with regard to FmHA and move to block these changes through legislation.

- If FCS were to default on its obligations and were unable to provide credit, the FmHA could face a substantial increase in demand for loans.

Option 3: Limit FmHA direct lending to servicing its existing portfolio. Eliminate FmHA real estate lending. Authorize FmHA to guarantee new operating loans up to a maximum of 70 percent under existing qualification rules.

Require the FCS to utilize its internal resources, restructure the FCA to provide it strong regulatory authority, endorsement powers, and Federal oversight, and establish an insured fund.

The Federal Government would provide a line of credit over and above the current $250 million or direct Federal financing for FCS from the Treasury.

Option 3 differs from option 1 by providing an additional line of credit from the Treasury to the FCS in exchange for formal restructuring of the FCS and FCA.

Advantages

- Providing Federal Government financing for the FCS could help achieve the needed reorientation of FmHA.

- It would permit the FCS and other private institutional lenders to remain a viable and competitive source of credit to individual operators while a new farm policy is implemented over the next three to four years.

- For the first time, there would be strong accountability for the individual institutions within the FCS.

Disadvantages

- The direct Federal budget exposure could be substantial with a significant risk that part or all of the direct Federal outlays would not be repaid.

- Providing the Federal Government financing for the FCS would delay the necessary restructuring of the farm sector.

- Commercial banks, insurance companies, and other lenders may object that the Federal Government is aiding only one component of the agricultural lending sector, and pressure the Government for access to similar resources.

Option 4: Limit FmHA direct lending to servicing its existing portfolio. Eliminate FmHA real estate lending. Authorize FmHA to guarantee new operating loans up to a maximum of 70 percent under existing qualification rules.

Require the FCS to utilize its internal resources, restructure the FCA to provide it strong regulatory authority, enforcement powers, and Federal oversight.

Consider creating a Federally-chartered, privately-owned credit institution (Aggie Mae) to purchase nonperforming farm real estate and equipment loans from any recognized financial institution.

Option 4 differs from option 1 by creating a Federally-chartered, privately-owned credit institution, Aggie Mae.

Advantages

- Creating an Aggie Mae could help achieve the needed reorientation of FmHA.

- It would permit the FCS and other private institutional lenders to remain a viable and competitive source of credit to individual operators while a new farm policy is implemented over the next three to four years.

- This proposal would avoid immediate direct Federal budget outlays and require State governments and private lenders to share the risk (through partial loan guarantees).

Disadvantages

- Creating an Aggie Mae could inhibit the necessary restructuring of the agricultural sector by providing a new source of subsidized credit to the sector.

- Creating an Aggie Mae with partial Federal guarantees of problem loans places the Federal Government at an unknown, but potentially large, risk.

- Creating an Aggie Mae would establish a precedent for other troubled lenders such as thrift institutions to seek a similar dumping ground for problem loans.

Recommendation

The Economic Policy Council unanimously recommends option 2.

Economic Policy Council Decision Memorandum

Agricultural Credit Policy
Summary of Options

_________ Option 1:

Limit FmHA direct lending to servicing its existing portfolio. Eliminate FmHA real estate lending. Authorize FmHA to guarantee new operating loans up to a maximum of 70 percent under existing qualification rules.

Encourage the FCS to solve its problems without Federal aid or interference.

_________ Option 2:

Limit FmHA direct lending to servicing its existing portfolio. Limit FmHA real estate lending to no more than current levels. Continue FmHA guaranteed loans under existing authorities (maximum of 90 percent guarantee) under existing qualification rules.

Encourage the FCS to solve its problems without Federal aid or interference.

<u>The Economic Policy Council unanimously recommends option 2.</u>

_________ Option 3:

Limit FmHA direct lending to servicing its existing portfolio. Eliminate FmHA real estate lending. Authorize FmHA to guarantee new operating loans up to a maximum of 70 percent under existing qualification rules.

Require the FCS to utilize its internal resources, restructure the FCA to provide it strong regulatory authority, enforcement powers, and Federal oversight, and establish an insured fund.

The Federal Government would provide a line of credit over and above the current $250 million or direct Federal financing for FCS from the Treasury.

_________ Option 4:

Limit FmHA direct lending to servicing its existing portfolio. Eliminate FmHA real estate lending. Authorize FmHA to guarantee new operating loans up to a maximum of 70 percent under existing qualification rules.

Require the FCS to utilize its internal resources, restructure the FCA to provide it strong regulatory authority, endorsement powers, and Federal oversight.

Consider creating a Federally chartered, privately-owned credit institution (Aggie Mae) to purchase nonperforming farm real estate and equipment loans from any recognized financial institution.

Regardless of any option chosen, the Administration has and should continue to express full confidence in the current financial condition of the Farm Credit System and its ability to continue to meet the challenges of the future.

James A. Baker III

James A. Baker III
Chairman Pro Tempore